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"An explanation of what determines the quantity supplied of money requires an analysis of the behaviour of commercial banks and of the central bank which has overall control of the banking sector."

Monetary Theory, Miles Fleming, p.28
Macmillan, London 1972

HIGHLIGHTS

The biggest surprise of 1993 will be the abortion of the U.S. recovery. It will come as a shock to policymakers, investors, speculators, especially hitting the dollar and world share markets.

There isn't the faintest basis for a self-feeding recovery in the crucial cyclical fundaments — money, credit, income and employment growth. On the contrary, unresolved structural impediments and persistent, extraordinary monetary weakness imply a relapse for the economy.

The swell in U.S. activity can only be temporary since it's founded on unsustainable factors — a huge deficit spending stimulus and a savings-financed consumption spurt. Both have nearly run their limit. Crucially, what's needed is investment led growth, in turn bolstering incomes.

What of the surging M1 growth? Doesn't it signal an economic recovery? Our analysis entirely refutes this widespread perception. The only thing it reflects, we say, is financial speculation.

We look into the misunderstood dichotomy between fast-growing demand deposits (M1) and shrinking savings and time deposits (M2 and M3). We find proof of a giant Ponzi scheme involving government securities.

If it were not for the massive monetization of the huge budget deficit through the government bond purchases of the Fed and the commercial banks, there would have been a savage money collapse perhaps as bad as in the 1930s.

Britain avoided the deep depression of the United States in the 1930s. We study the divergent performance of these two economies during that time and uncover some important lessons. Why did ultra-easy money fail so miserably in the U.S. while succeeding splendidly in Britain? The mistakes are again being repeated in the U.S. today and in Britain, too.

Looking for a solid recovery, the key requisites are exports, investments, business profits, and private credit growth. In the U.S., Britain, and Canada, all these vital cyclical components show prolonged and endemic sluggishness.

The dollar should fall further as economic weakness becomes more pronounced. Hard currency bonds — the top-quality government bonds of Germany and Switzerland as well as Austria, Belgium and the Netherlands — remain the safe haven for prudent long-term investors.

THE FALLACIES OF SUPERFICIAL PERCEPTIONS

Now, after the fireworks of the late months of last year, could it be possible that currency markets have finally quieted down . . . or is it more likely that they're just passing through the eye of the storm? Has the battle for the honour of the French franc been finally and convincingly settled? And as a confusing stream of opinion reports would beg, is it a DM crisis we're heading for or a dollar crisis? These are all weighty questions . . . ones that require careful answers. Even as we write, the Irish punt is crumbling and the British pound is back near new lows. But really, we think, it all boils down to a single question: Is the U.S. economy safely on track and of sufficient momentum to pull the world economy out of its doldrums as the consensus believes? If so, with a strong dollar, indeed, currencies would stabilize. Otherwise, there will be trouble. Therefore, we need to continue focusing on the U.S. economy.

It's an old truth that markets are most strongly impacted by the events that take them by surprise. The inverse holds true, too. The things that are most expected have the least impact. What are the most anticipated and publicized events of 1993? A solid, enduring economic recovery in the United States and a swooning European economy dragged down by a recessionary Germany. The certain expectation that German interest rates must therefore fall precipitously, has led to the accepted wisdom of an imminent demise in the D-mark — a soaring U.S. dollar, in other words. There hasn't been such a strong consensus on the DM/US rate since the period following the 1991 Gulf War. It must be obvious that the whole world has gone short the D-mark and exposed themselves heavily to the dollar. The bets proved badly wrong in 1991. What is the oversight this time?

The biggest surprise of 1993, we think, will be the abortion of the U.S. recovery. It will come as a shock to policymakers, investors, traders and speculators. In our opinion, the resulting tumble in the dollar will also end France's "franc fort" policy, its desire to establish a solid currency. Having said this, we want to stress that we aren't very optimistic at all about the German and European business picture. However, for these economies the worst already appears to be discounted gauging from the extreme pessimism that already prevails. Our main reservation in this case is that the Bundesbank will be slower in lowering interest rates than the markets think. But to repeat, the big surprise in 1993 will be a new downturn in the U.S. economy.

A THICK CONSENSUS

We have consistently warned that the essential conditions for a sustained U.S. economic recovery are starkly absent. We realize that we have very little company in our view. Should that worry us?

In general, among economists we find that there is a hugely-excessive churn out of forecasts, lots of incoherent number manipulation and very little thinking and reasoning . . . not to mention independent thinking. The overwhelming uniformity in the tone and substance of most reports undeniably attests to that statement. Even institutions that have nothing to do with the markets — international organizations such as International Monetary Fund (IMF) and the Organization of Economic Cooperation and Development (OECD) — follow a similar script. The predictions of their economists over the past three to four years have fared no better.

Actually, by now, it is widely recognized in many countries that the present economic and monetary

environment differs fundamentally from the normal postwar business cycle. This implies, of course, that the standard postwar experience has little value in assessing current conditions. We need to search for the causal links that underlie the new and strange environment. That's just what most economists fail to do and that's why this type of investigation merits comprehensive treatment in our letter.

THE FED'S AGGRESSIVE MONEY PUMP

Probably, the most obvious and most striking anomaly is found in the U.S. monetary sphere. Looking at soaring narrow money (M1), skyrocketing bank reserves, the extremely low short-term interest rates and the wide spread between short-term and long-term rates, U.S. monetary policy appears aggressively stimulative. But looking at the persistent, unprecedented weakness in broad money (M2 and M3), monetary conditions appear highly restrictive.

Given the crucial importance of money, you would think that economists — particularly at the Fed — would carefully investigate the possible causes of the anomalies in the monetary picture and try to fathom their implications. Instead, everybody is simply cherry-picking the statistic that suits their outlook. One group points to the surge in M1 and bank reserves and cries warnings of inflation while another group points to the weak broad money aggregates and predicts deflation.

The first aspect of this conundrum to investigate is the unusual strength of M1 and its implications. Any such enquiry must start with the realization that changes in the money supply result primarily from the lending and investing activities of the banking system. It is this action that causes corresponding changes in bank liabilities — the deposits that make up the bulk of the money figures.

During the last two years, U.S. commercial banks expanded their total assets by about $200 billion. What accounted for this increase? Almost solely, government bonds. Seeing these figures, it's important to recognize what is going on: the commercial banks are flooding the economy with newly-created money though they aren't doing it in the normal way by expanding their loans to businesses and consumers. This time, they're doing it almost exclusively by monetizing the budget deficit.

The reason for the banks' insatiable appetite for government bonds is well-known. With deposits generally paying less than 3% interest, Treasury bonds that yield 5-6% are seen as a riskless, fat bargain. Yet, there is a snag. In buying these bonds, the banks create demand deposits which are subject to reserve requirements (balances to be deposited with the Federal Reserve). Not surprisingly, these reserves at the Fed have been soaring at an annual rate of 30%.

Normally, such a sharp rise in reserve requirements would drastically tighten the money market and drive up the Fed funds rate. Not so this time. The reason is that the Fed, by making heavy purchases of government bonds as well, is actually supplying whatever amount of reserves the banking system needs to continue its stampede into government bonds.

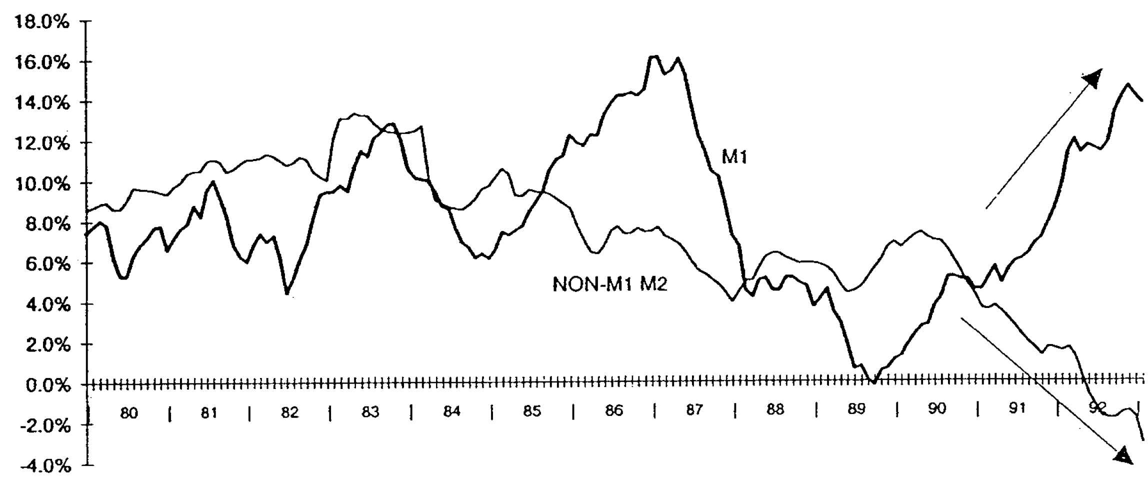
For the banks, it is no exaggeration to say that financing the bottomless Federal budget deficit has become their exclusive business, thanks to their cheap deposit base, while lending to the private sector has fallen into oblivion. For the government, incidentally, this generous reserve stance on the part of the Fed has the effect of shifting the costs of rescuing the banking system from the taxpayer and the

Federal budget to the small saver. It is this person who holds the bank and thrift deposits where yields have been trimmed to the bare bone. Mr. Alan Greenspan seems to be proud of this achievement.

A BIZARRE MIXTURE OF INFLATION AND DEFLATION

Mainly by way of monetizing the budget deficit, the Fed and the commercial banks jointly managed to increase M1 by a huge $126 billion or 14% last year. But where has all this new liquidity gone? This brings us to the most ominous feature in the U.S. monetary picture. Viewing the broad money measures (M2 and M3), one sees overall liquidity showing unprecedented stagnation. M3 last year gained a mere $6 billion, by far the lowest annual increase in the whole postwar period. What is happening is that the large-scale money creation perpetrated by the heavy monetization of the budget deficit is virtually being offset by an equally large money destruction in the private sector.

UNITED STATES: M1 VERSUS NON-M1 M2 GROWTH
Year-over-year % Change, Monthly



Source: Federal Reserve Bank of St. Louis

To understand this, you have to look at another part of the credit system — thrift institutions. The savings and time deposits of the ailing S&L's represent a sizeable component of M2 and M3. After a long period of brisk growth, S&L deposits peaked in 1978. During the last three years, their credits and deposits have reciprocally contracted by about $300 billion. What's worse, this process of credit and deposit shrinkage continues among the S&L's. The salient point to see here is that this shrinkage implies a corresponding decrease of M2 and M3. To see what's really going on, you have to look at M1 and the part of M2 that excludes M1 (M2 includes M1), as shown in the above graph.

The second important factor behind the weakness of broad money is the virtual cessation of bank lending to the private sector. Since banks therefore don't need to compete for deposits, they have slashed their deposit rates to levels that tend to drive depositors into alternative investments, like mutual funds, stocks and bonds.

Taking stock, we find three grossly divergent, major influences on money and liquidity growth: (1)

the rampant money creation by way of the huge bond purchases of the Fed and the commercial banks; (2) the drastic contraction of S&L credits and deposits which is reflected in the extraordinary weakness of M2 and M3; and (3), the virtual absence of bank lending to businesses and consumers.

First and foremost, all this destroys the comforting notion that America's credit woes are largely a thing of the past. One of the startling insights that falls out of the above analysis is this: If it weren't for the massive monetization of the huge budget deficit through the government bond purchases of the Fed and the commercial banks, there would have been a compounding debt and savage income deflation . . . perhaps as bad as in the 1930s.

Analyzing the monetary trends, it is important to come to grips with the messages of unusually strong narrow-money growth and record-low broad money growth. For one, it has produced an unprecedented, bizarre mixture of inflation and deflation. The budget deficit and the stock and bond markets — the financial system — continue to enjoy the stimulus of rampant inflation. On the other hand, businesses and consumers retrench under the pressure of compounding debt and the profit and income deflation that stems from the economy's structural problems. While the Fed's monetary liberality hyper-stimulates the financial world, it fails to stimulate the real world.

THE STRUGGLING REAL ECONOMY

Looking at the real economy, the key issue really is whether or not the debt and structural problems that have impaired growth during the past years are on the mend. The consensus finds its conclusive, positive proof primarily in the apparent economic recovery. We beg to differ.

In the first place, this feeble economic upturn is of a highly artificial nature. It has long been agreed that in order for the U.S. economy to enter onto a path of healthy growth, it is necessary for the budget deficit and consumption to be cut in favour of higher savings, investment and exports. Ironically, all three of these elements are the main casualties of this recovery.

Importantly, are the economic forces working toward a balance . . . that is, toward an improving structural foundation? We don't see any sign of it. There is much talk of debt deflation and the healthy slowdown in private debt growth. While that may be true, government debt has been soaring. It's frightening to consider the sheer volume of debt that's required to generate growth, and only feeble growth at that.

Despite a lot of deficit-reduction rhetoric, the federal deficit has doubled under the Bush administration from $153 billion to $300 billion. Considering the massive monetization of the deficit, as implemented by the Fed, this has been the most prodigious fiscal demand stimulus ever launched, even beating Reaganomics. Seen in this light, what's remarkable is not that there's a recovery, but that the recovery has been so feeble and shaky. Essentially, the surging deficit bolstered incomes and profits. But for policymakers, the long-term cost is a budget deficit that's now at a new record level.

THE CONSUMER IS UNABLE TO LEAD

It is now generally believed that the U.S. consumer is on the road to better financial health. That, too,

is a rather optimistic interpretation. It's true that one thing has improved: the Fed's drastic lowering of borrowing costs has lightened debt-service burdens. But that only takes account of one side of the ledger. This reasoning conveniently overlooks that these interest-rate cuts impose far greater losses on consumers as a whole because personal interest income is about six times as high as personal interest payments.

In sum, the lightened debt burdens are hardly a sign of improving consumer liquidity. Changes in consumer purchasing power are chiefly determined by income growth and capital gains on real and financial assets which in turn tend to fuel consumer borrowing. During the 1980s, both of these contributors to consumer purchasing power were working in high gear. The new reality, though, is that these two engines have virtually sputtered out. With no changes in sight in this respect, the consumer is clearly unable to lead a recovery.

NOT DEBT INFLATION BUT A "CROWDING OUT"

We are often asked whether the U.S. economy will ultimately veer off into a inflationary spiral or fall into a deflationary abyss. The answer is more difficult than may be thought. For the time being, as already explained, there already exists a bizarre mixture of inflation and deflation. In the area of public debt and the stock and bond markets, we witness rampant inflation as reflected in ballooning M1. For the real economy — the real estate markets, employees and their incomes, businesses and their profits, and private credit — there are strong deflationary forces at work.

American economists like to speak of disinflation or deflation, citing low inflation rates and sharply reduced private borrowing as evidence. They view these trends as comforting proof of improving economic and financial health. Actually, this is a bogus argument.

During the twelve months to the end of September 1992, total U.S. public and private debt grew by $497 billion. During this same period nominal GDP grew by $279 billion. That means every new dollar of GNP required the propellant of $1.80 in incremental debt. That's an extremely high debt-to-GNP ratio, one that should more appropriately be called a debt inflation. What it shows is that the disastrous upward trend of debt versus GNP continues at an undiminished pace.

What's happening is a drastic shift in borrowing from the private sector to the public sector. Of the total debt increase of $497 billion mentioned above, no less than 74% was accounted for by the public sector (federal, state and local governments). Consumers borrowed the balance, while corporations raised a net $35 billion through equity issues.

To say that there is a debt deflation misses the key point in this negative development. What's really happening is that private credit and investment are being "crowded out." The heavy government borrowing weakens the economy through two channels: (1) by keeping the most important interest rates — long rates — at an elevated level; (2) by consuming savings that otherwise would be available for private investment thus impeding future gains in productivity and living standards. Future generations inherit a smaller and smaller capital stock which supports a larger and larger pile of non-productive debt, all at the expense of their future living standards.

THE UNSUSTAINABLE RECOVERY

Assessing U.S. economic prospects, it is necessary to consider and distinguish between three distinct aspects: (1) structural afflictions which impair long-term growth — a high budget deficit, low savings and investment; (2) the short-term cyclical outlook; and (3), conditions for financial markets.

With respect to structural problems in the U.S., the answer is clearly apparent. Not only is there no improvement, there is a drastic deterioration: a skyrocketing budget deficit coincides with a new decline in personal savings. The level of government borrowing relative to private savings (corporate and personal) is at its worst ever. The total savings of the private sector are totally taken up by the budget deficit leaving nothing for economic growth.

As to the question of the cyclical nature of the U.S. recovery, our answer is equally clear: There is nothing in sight that could foster a self-sustaining recovery. The main impetus for 1992 U.S. GNP growth was a big fiscal boost. A second boost to the economy occurred in late 1992 as consumers financed a spending spree by dipping into their savings. The salient and decisive point to see at this juncture is that these two boosts together have yet to initiate a self-reinforcing cyclical economic recovery.

Looking for indications of a solid recovery, the key requisites to focus on are exports, investments, business profits, and private credit growth. In the U.S., Britain, and Canada, all these vital cyclical components show prolonged and endemic sluggishness. Building activity, although somewhat improved, remains depressed following the past overbuilding excesses. A chronic weakness in business investment has its obvious central cause in inadequate profitability. The most ominous feature common to all three counties is a persistent, secular decline in profits over the past two decades. The recent improvement in U.S. profit margins stems largely from the sharp cut in interest rates, which lowers interest costs, and the stimulus of a sharply higher budget deficit. Nonetheless, corporations everywhere are continuing to mercilessly slash jobs in their efforts to resuscitate profits.

Our summary verdict on the U.S. economic recovery? It looks stronger than it really is. Some of the growth is real, but it isn't sustainable. Much of the apparent growth is really due to distorted seasonal adjustments as explained in the last letter.

FINANCIAL BOOM VERSUS A LACKLUSTRE ECONOMY

We come to the third question: What does all this imply for the financial markets? The investor must ponder how the probable economic trends will impact the financial markets and his own investments. So far, Wall Street has greeted the sub-par economic performance as the best of all worlds, providing a blissful combination of strong bonds, strong stocks and the rationale, in their minds, for a strong dollar. But it is a pattern that cannot last because the assumptions underlying the three different speculative bubbles are grossly contradictory and incompatible.

It is our long-standing view that a multitude of structural problems will keep the U.S. economy trapped in a slow-growth malaise for years to come. The whole situation in the U.S. essentially implies a need for permanently low, if not lower short-term interest rates. On the other hand, a large and rising

budget deficit keeps long-term interest rates at a much higher level. These two dynamics create the steeply inclined yield curve that continues to lure banks, brokers and other speculators into playing the magnificent money machine of buying bonds financed by short-term loans.

These conditions are not confined to the U.S. alone. A similar blend of conditions — a ballooning budget deficit, serious structural problems, extremely slack private sector demand for credit and sluggish private investment depressing the real economy — is prevalent in Britain and Canada as well.

THREE SEPARATE SPECULATIVE BUBBLES

Let's start with the overvalued stock market. Wall Street likes to rationalize its buoyant trend with the argument that it's "liquidity driven." That appears true if one looks at the narrow money measure, soaring M1. But gauging from the broad money measures (M2, M3 and M4 or L) liquidity is tightening as never before in the postwar period. How does one make sense out of this glaring contradiction?

In the case of the stock market, what's clear is that the fires of speculation have been stoked by the small investor. Fanned up by the slide in yields on bank and S&L deposits, the small investor poured more than $350 billion into stock and bond mutual funds during over last two years. A considerable part of these flows end up in the stock market.

That brings us to another fallacy in the interpretation of the U.S. monetary development. It concerns the impact of these specific flows on the money supply. For some time, the ominous sluggishness of broad money was attributed to these "portfolio shifts" — funds flowing from deposits (money) into stocks and bonds which are outside of the money supply. We have always countered that this reading is grossly mistaken. All that happens in the purchase of these securities is that existing savings and time deposits are turned into demand deposits (M1, chequing accounts, for example) which then accrue to the sellers of the securities. M1 soars as a consequence of this massive shift of funds, yet M2 and M3 shouldn't be diminished since these aggregates include M1. Portfolio shifts in no way account for the sluggish broad money growth.

Still, the stock market bubble hinges critically on the bond bubble which is the main source of money creation in the United States. We already described the mechanism earlier. By making heavy purchases of government bonds, the Fed boosts reserves and pushes the banks to increase their balance sheets. That's exactly what the banks are doing, not by lending to businesses and consumers but through massive purchases of government bonds. Virtually the entire money creation flows in the direction of the government. Describing similar conditions in the 1930s, Schumpeter wrote that money creation for government spending tended to create idle deposits. His point was that investment and government spending have entirely different dynamics.

TWO DIFFERENT OUTLETS FOR MONEY

So much for our analysis of U.S. economic and monetary conditions. What has emerged is the picture of an extremely imbalanced development in the money and credit sphere which reflects extremely imbalanced developments in the real economy. The most perplexing feature is the co-existence of a

financial boom and a flagging economy.

In reality it has a perverse logic if you realize that money always has two different outlets. Some portion of the total money supply is employed in transactions related to goods and services that make up GDP; another large portion is employed in capital asset transactions — the buying and selling of stocks, bonds, and real assets. The distribution of money demand between these two markets is not fixed. If the conditions in the real economy appear unattractive, the money floods overproportionately into the financial sector, inflating security values. Keynes observed that the financial circulation steals money from the industrial circulation.

In sum, what we see in the United States is the following: on the one hand, a huge M1 bubble which is the direct outgrowth of budget deficit-driven inflation and frenetic financial speculation; on the other, shrinking savings and time deposits giving rise to extraordinary broad money weakness reflecting the contraction of private sector demand for credit and money.

WATERLOO FOR THE DOLLAR

While U.S. bond and stock market speculation is feeding on the flight from low interest rates, the dollar bulls have been betting on the opposite: that a strong U.S. economic recovery will drive up U.S. interest rates. The futures markets had already discounted a rise in short-term Euro-dollar rates to levels of 5% and higher by year-end 1992. The trouble is that neither the stock nor bond market bubble would survive such an adverse move in interest rates. Banks, brokers and others playing the U.S. yield curve would be forced to dump bonds by the hundreds of billions of dollars, thus driving up long-term interest rates and pulling the rug out from under the stock market.

Instead, the dollar has suddenly sagged although nothing dramatic has happened. A mere change in expectations relating to the DM/dollar interest-rate differential seems to be the culprit. It is now being realized that the Bundesbank will bide its time in easing. But it should be clear that weakness is localized in the dollar considering the fact that the dollar has slumped against all currencies, including the Japanese yen.

The fact that there was far too strong of a bullish consensus on the dollar proved to be part of its undoing. Given all those uniform and cocksure bullish forecasts from banks, brokers and investment managers, it was evident that the whole world had overinvested in dollars hoping to reap the big currency gains that the experts were unanimously predicting. The big Clinton rally failed to materialize because the markets had already fully anticipated it.

Dollar bulls are now faced with a gut-wrenching question: Is the recent downturn in the dollar a mere temporary correction in a bull market, and therefore, an ideal buying opportunity, or is it something worse? To start with, it's illuminating that dollar bullishness remains quite strong.

As we have seen, dollar bullishness had two different components — deep pessimism on Europe on the one hand, and optimism on the U.S. economy on the other. It seems to us that market pessimism on Europe and Germany has reached a point that couldn't sink much lower. The most significant change, heavily impacting U.S. financial markets and currencies, has clearly occurred in the perception

towards the U.S. economy. Increasingly, investors and speculators are awakening to the fact that the generally projected rates of U.S. 1993 GNP growth of between 2-3% would be too weak to vindicate the sharp rise in U.S. short-term interest rates, on which the dollar bull case crucially rests. In short, a few dollar bulls, although not many at this point, realize that they got it wrong on U.S. interest rates.

In our opinion, this beginning recognition is the first blow to the dollar. The next one to follow will be a growing realization that the U.S. economy will be unable to maintain its modest momentum, raising concerns again about renewed recession. The extremely one-sided talk about the European calamities has unduly deflected attention from the far worse structural problems that are depressing the U.S. economy and, even more so, the British and Canadian economies.

AN INSTRUCTIVE PRECEDENT — THE 1930s

In the end, we are left with the key question: Are the world economies — the U.S. economy in particular — moving in the direction of inflation or deflation, recovery or relapse? As we've already shown in the U.S., the situation is far too complex to be wholly answered by either extremes. Our analysis has exposed a set of incidences in the United States that has not been seen in the whole postwar period — the lowest Fed funds rate in 30 years, the steepest yield spread between short and long interest rates in history, soaring bank reserves and narrow money (M1) while broader money shows unprecedented weakness. On the other hand, we've witnessed the longest ever period of economic near-stagnation. The situation doesn't allow for customary answers.

To find a parallel, we have to go back to the 1930s. At that time, a similar peculiar experience was captured in the aphorism "*you can't push on a string*." America was the major country that fared the worst in the 1930s.

Immediately after the stock market crash of October 1929, the Fed had aggressively eased. Altogether, it slashed the call money rate by 750 basis point down to 1%. By comparison, today, since 1989, the Fed funds rate has fallen by nearly 700 basis points to 3%. Since bond yields declined much less in both periods, steep yield curves emerged. Another striking parallel of both periods are the soaring bank reserves.

Following the downturn of the early 1930s, the United States actually experienced a substantial recovery over the four years from 1933 to 1937. Industrial production rose from an index level of 64 in 1932 (the average of 1923-25 levels equals 100) to 116 as compared against a peak of 121 in 1929. Industrial production failed to regain its former peak. But even this level could not be maintained. In 1937, there followed a new slump almost as deep and even more precipitous than that of 1929. Within less than one year, production had fallen back down to a level of 75, far below the 1929 peak.

THE DISASTROUS FAILURE OF PUMP PRIMING

The present policy discussions in both Britain and the United States draws us to make some further comparisons between the economic situations of the 1930s and today. What we find, as is so often true, is that the comforting conclusions of today's policymakers are wrong.

For many Anglo-Saxon economists, cheap money and currency devaluation are the surefire panacea for an ailing economy and will never fail to stimulate growth. The model case they cite to support this view is the British policy experience in the 1930s. After abandoning the gold standard in September 1931, Britain indeed enjoyed a spectacular recovery. The main policy measures were (1) ultra-cheap money with a bank rate as low as 2.5% and (2) a drastic 40% devaluation of the pound combined with the adoption of stiff Empire tariff preferences. By 1937, industrial production had rebounded 50% and was over 20% higher than in 1929.

In light of this rosy experience, it is believed, all that's needed for an economic recovery in Europe today is to break free of the constraining burden of the D-mark. It's not surprising that there was immediate euphoria in the City of London when the government allowed the pound to fall last year. "Go for cheap money and let the currency fall and all of our problems will solve themselves," was the general cry.

Strangely, these financial professionals completely overlook the disastrous warnings of the U.S. experience in the 1930s. The most important lesson to draw from the 1930s period was not the relative weakness of the other European countries — the gold bloc — seen against Britain, but the frightening and catastrophic experience of the U.S. economy.

American anti-depression policy lined up with that of Britain in two respects: (1) ultra-cheap money and (2) drastic currency devaluation — the U.S. dollar dropped 41%. What worked so splendidly in Britain utterly failed in America. Is there an explanation? Yes, and we think it's highly relevant to today's situation in the United States, Britain, Canada and many other countries.

What were the key differences, both in terms of policy and the economic situation, that gave rise to the two different outcomes? As to policy, the most striking difference was that the American government, in addition to a policy of easy money, embarked on course of heavy deficit spending. As well, U.S. expansionist policies were marked by extensive government intervention and planning, first under Hoover, then increasingly under Roosevelt's New Deal. Wage rates and prices were bolstered, weak industries and firms were propped up by easy and cheap credits from special government institutions, competition was eliminated. For years the federal deficit hovered around 5% of GNP.

By contrast, the most remarkable fact about British economic policy during the decade was the strict avoidance of any budget deficit. British policymakers and most British economists — with the notable exception of Keynes — were radically opposed to deficit spending.

There were also key differences between Britain and the United States in their economic developments. In Britain, a strong recovery was led by a building and investment boom. In the U.S. case, by contrast, the 1930s recovery proved to be feeble and fragile mainly because investment and building failed to take the lead. The central failure of "pump priming" was its inability to revive investment.

CONCLUSIONS

Looking at the world situation today, we note that there is much in common with the U.S. economic

and financial scene of the 1930s. Overall, we would say that things are even worse. Huge budget deficits coincide with chronic weakness in investment and rampant financial speculation, fuelled by increasingly aggressive monetary easing.

Essentially, the large budget deficits have the most serious consequences in the countries with low savings. It is primarily the English speaking countries — notably but not exclusively the United States, Britain, and Canada — that have the worst situations in this respect. They are all stuck with high long-term interest rates which tend to frustrate the stimulative effects of low short-term interest rates and rising budget deficits.

While the buoyant stock and bond markets feed off the prospect of easier money, the currencies — fixed or floating — are the first to come under fire. The recent fall of the Irish punt has again given the currency markets another taste of blood. The battle for the French franc will now likely enter a new critical stage.

In the end, the outcome of the currency battles will be determined by the relative performance of the underlying economies and the staying power of the national central banks in the face of economic weakness.

For the U.S., the decisive point to see is that its structural problems, which are at the root of the prolonged economic malaise, are getting worse, not better.

Our careful analysis reinforces our opinion, though it radically disagrees with the consensus: A new economic downturn in the U.S. is virtually assured.

Our investment recommendation remains the same. For safety, good yields and capital appreciation, hard currency bonds — the top-quality government bonds of Germany and Switzerland as well as Austria, Belgium and the Netherlands — remain the safest investment preserve for prudent long-term investors.

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